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ISSUES IN SOCIALIST ECONOMY REFORM

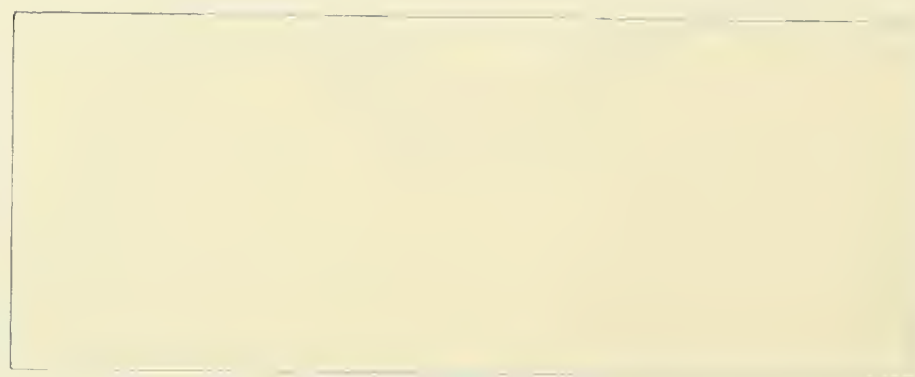
Stanley Fischer  
Alan Gelb

Number 567

November 1990

**massachusetts  
institute of  
technology**

**50 memorial drive  
cambridge, mass. 02139**



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ABSTRACT

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We examine issues about the design and sequencing of economic reform in formerly socialist economies that have made the political decision to move to a private market economy. We also examine the potential role of foreign countries, in providing aid, technical assistance, and market access.


In economies that start from a situation of actual or potential macroeconomic instability, macroeconomic stabilization and accompanying measures to harden budget constraints and create an emergency social safety net are the first priority. Price reform, implemented with the assistance of trade liberalization, and enterprise restructuring and privatization are then at the center of the reform process. Banking reform, training, and the development of other financial markets has to begin immediately, but the ability of the financial system to allocate resource efficiently will remain limited until enterprise and price reform are sufficiently advanced. In the context of system-wide reform, the notion of sequencing should be replaced by that of packaging: a large number of interrelated reforms, including those needed to create an appropriate legal structure and develop skills needed in a market economy, has to be put in place very early, though the speed of implementation will differ. However rapid the initiation of reforms, their completion -- especially privatization -- is bound to take many years.

Stanley Fischer  
E52-280, MIT  
Cambridge, MA 02139

Alan Gelb  
N 6037, The World Bank  
Washington, DC 20433

(617) 253-6666

(202) 473-7667



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## ISSUES IN SOCIALIST ECONOMY REFORM

Stanley Fischer and Alan Gelb<sup>1</sup>

### I. Introduction

The formidable challenges facing the reforming European Socialist Economies (ESEs) are frequently said to be unique. In fact, most of the individual requirements for socialist economy reform have been faced before, in China, and in Latin American and African countries where the combination of a weak private sector, political monopoly, heavy policy-induced distortions and macroeconomic imbalance is not uncommon. There are also lessons to be drawn from the earlier reform experiences in Yugoslavia and Hungary. Nonetheless the challenge is unique, in its system-wide scope, in its political and historical context, and in the speed of desired reform.

Few socialist countries remain unreformed planned economies. In the last decade several — for example China — have instituted some economic reforms, while trying to preserve the state's monopolies on political power, the savings-investment process, and social ownership. However, countries such as Hungary, Poland, Czechoslovakia, and Bulgaria — and increasingly, the Soviet Union — seek fundamental change leading to a pluralist political

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<sup>1</sup>/ Fischer is Professor of Economics at MIT, and a Research Associate of the National Bureau of Economic Research; Gelb is Chief of the Socialist Economies Unit of the World Bank. Work on this paper was begun when Fischer was Chief Economist at the World Bank. Opinions expressed are those of the authors, and are not official views of the World Bank. The authors are indebted to Bela Balassa, Olivier Blanchard, Rudiger Dornbusch, and Imre Tarafas for helpful comments.

system, well-defined and substantially private property rights, and market-based allocation processes. Yugoslavia should by most criteria be included here, but in light of its long history of reform and political independence, and non-membership in the CMEA (Council for Mutual Economic Assistance), regards itself as — and is — sui generis.

In this paper we consider the reform process in countries that have made the decision to move from a more or a less-planned socialist system to a private market economy, one in which private ownership predominates and most resources are allocated through markets. Such reform demands the creation of management skills, and legal, regulatory and infrastructural conditions, whose development has been set back by decades of socialist development. It also requires fundamental changes in the role and the capabilities of the state.

We do not treat the close interrelationship between economic and political reform at any length in this paper.<sup>2</sup> However, we note that the important strategic choices in the reform process arise out of the interplay between economics and politics: technocratic solutions alone will not be sufficient in deciding on the path and speed of the reform process. Because the reform process is both intertwined with political factors and economically complicated, and because there are substantial differences among the reforming countries, no single detailed road map can guide the way to the new systems. Therefore the paper sets out general considerations that provide a framework

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2/ Political reform prior to economic reform may be needed to prevent the latter from being stalled by an entrenched bureaucracy. But, reflecting the complex political-economic interactions, successful, partial, economic reform can provide space for political reform. Providing alternative private career paths for the nomenklatura (a contentious issue in several countries), could also ease certain aspects of political reform.



for reform, and relates the choices to some initial conditions of the various reforming countries. In the metaphor of Vaclav Klaus (1990), the Finance Minister of Czechoslovakia, undertaking reform is like playing chess: one needs to know the rules and have a sense of strategy, but it is not possible to plan each specific move at the beginning.

Interdependence between reforming socialist countries is also very important, but the problems posed by the January 1991 reform of the trade and payments institutions of the CMEA will not be addressed at length.<sup>3</sup>

## II. Initial Conditions for Reform

Recent data on the economies of ESEs and the USSR are presented in Table 1. Estimates of GNP, aggregate or per capita, vary widely, depending on the source and the conversion method, and none can be regarded as accurate.<sup>4</sup> The 1988 CIA estimates are well above rates calculated through the exchange rate; the latter are more relevant to the borrowing status of actual and potential members of the World Bank.<sup>5</sup>

In any case, income levels in the ESEs appear to be above the average of

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3/ The CMEA is an essentially bilateral system of trade relations, with the Soviet Union being the dominant trading partner of each of the smaller East European countries. Yugoslavia is not a member of the CMEA. Payments among CMEA countries are expected to be made in hard currencies, at world prices, from the beginning of 1991.

4/ The estimates shown in the row "GDP Physical Indicators" are close to purchasing power estimates of real incomes. See Fink and Havlik (1989) for discussion of alternative income estimates.

5/ The exchange rate based estimates — which use actual exchange rates for countries such as Poland and Yugoslavia that have reformed their exchange arrangements, and staff estimates for other countries — imply that all ESEs would be eligible World Bank (IBRD) borrowers by the income criterion.



Latin America, but well below those of Western Europe. Until recently, East Germany was thought to be the most advanced of the ESE countries, with the CIA suggesting in 1989 that per capita income was over 60 percent of the United States level. A closer look at East Germany has persuaded many that Czechoslovakia has the highest per capita income, with Hungary the next, but this view could change with closer examination of the other countries. Poland and Hungary are heavily indebted in convertible currency, and Yugoslavia has borrowed intensively.

As measured by their reported Gini coefficients of around 24 (the same as Norway and a little higher than Sweden), income is relatively equally distributed in the ESE countries; Gini coefficients in the range 30-35 are common for industrial market economies.<sup>6</sup> By international standards, social indicators such as longevity and literacy are high for the income levels of these economies, though there has been a relative decline in their social indicators during the past decade and some evidence of recent retrogression.

The ESEs experienced similar growth patterns after the immediate post World War II period. Growth at the extensive margin, based largely on the accumulation of capital through very high investment rates, and increasing labor force participation, was quite rapid until the seventies, although there was probably less technical progress than in Western Europe. In the late seventies growth gave way to stagnation, worsening shortages, and, in some countries, worsening macro-imbalances. By contrast with Western Europe, there

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6/ Inter-regional income differences account for much of the observed inequality in socialist countries, essentially because of limited equilibrating factor market resource flows. This is why Yugoslavia's Gini coefficient is relatively high; for discussion of this effect in rural China see Byrd and Gelb (1990)

was no recovery in the first half of the 1980s.<sup>7</sup>

Despite the broad similarities in the structures of the ESE economies, important differences in initial conditions will shape their reform processes:

- 1) The extent of macroeconomic imbalance, both internal and external;
- 2) The degree of decentralization of economic management and extent of product markets prevailing before system reform begins; and
- 3) The extent of private sector activity prior to reform.

Figure 1 depicts the first two initial conditions — macro imbalances, and management decentralization — of seven countries.<sup>8</sup>

Macro-imbalances. Domestic macro-imbalance in a socialist economy can take various forms, from open inflation to the involuntary accumulation of financial claims because of the rationing of acceptable goods and/or the absence of alternative assets (the monetary overhang). Poland probably embarked on reform from the worst macro position, with an overwhelming debt problem and high inflation. Yugoslavia was in better shape on the external side but also suffered from very high inflation and enormous domestic losses in the banking system which threatened macroeconomic stability. The USSR and

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7/ Like estimates of real income, the growth rates of the socialist economies are the subject of debate. In some cases, including East Germany, high reported growth rates are known to have resulted from statistical manipulation. Nevertheless, the general picture in European socialist countries is of quite high growth rates declining sharply from the latter half of the seventies and stagnation through a period of attempts at reform. This is very different to China, which stagnated prior to the reforms initiated in the 1970s, and grew rapidly thereafter (Chen and Singh 1990).

8/ The relative positions of countries in Figure 1 necessarily reflect a degree of judgment. Some countries included in Table 1 are omitted from Figure 1 for lack of information.

Bulgaria face major macro-imbalances. Internal disequilibrium appears to be relatively larger in the former but the burden of foreign debt is much lower, especially if account is taken of substantial gold reserves.<sup>9</sup> Hungary has the largest external debt per capita and persistent inflation of about 20 percent, but a relatively small budget deficit. With low foreign debt and probably only moderate domestic imbalances, Czechoslovakia appears to be in the best macro situation. East Germany is, of course, a special case because it has been reformed out of existence, in a process involving the underwriting of foreign debts and any monetary overhang by the Federal Republic.

The extent and type of macro imbalance prevailing before reform has an important bearing on the potential speed and design of structural reform programs. Although it can be one of the ways to eliminate a monetary overhang, the inflation that will accompany liberalization from a position of repressed excess demand is likely to cause serious economic and political difficulties for reform. Although the elimination of the monetary overhang should in principle be possible with a one-time change in the price level, rising prices may even accentuate the flow disequilibrium by worsening the

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9/ In March 1990 the USSR published a list of its debtors and identified overall international assets of \$145 billion, of which \$74 billion was owed by CMEA members and \$ 71 billion by developing countries: Oxford Analytica, 7/26/90. It is not clear to what extent these debts are collectible, but on paper at least the USSR has thus developed a substantial net international credit position, which could give it some leeway in adjusting its external accounts. Bulgaria has also extended credit to developing countries, notably in the Middle East. Reform of the CMEA system will probably be to the advantage of the USSR but adverse for Bulgaria.



fiscal balance<sup>10</sup> — thus potentially turning what should be a one-time change in the price level into a more persistent increase in the inflation rate. High open inflation has to be eliminated for structural reforms to be effective. Eliminating excess demand is also important for microeconomic reasons: studies of firms in socialist countries suggest that the shift from sellers' markets to buyers' markets is essential in modifying firms' efficiency and customer orientation.

Countries close to macroeconomic equilibrium have greater latitude to implement those institutional reforms most needed to support the operation of markets before switching over to market mechanisms.<sup>11</sup> Those needing urgent stabilization face difficult decisions of sequencing stabilization measures (which in the past have typically involved the tightening of controls) and structural reforms leading to a market system.

Markets and Decentralization Turning to the other axis of Figure 1, at the start of 1990, Czechoslovakia, East Germany, the Soviet Union, and Bulgaria had relatively centralized economies, with a planned materials supply system playing a major role and with enterprise management subject to the constant intervention of ministries.<sup>12</sup> By contrast, Yugoslavia has long been

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<sup>10/</sup> This could happen as a result not only of the Tanzi effect, in which real tax revenues decline as inflation rises, but also because partial price decontrol may require increasing government subsidies to maintain the prices of necessities constant.

<sup>11/</sup> For examples of authors who advocate such a pattern, where the institutions needed to support markets are put in place prior to each stage of liberalization, see Svejnar (1990) and the so-called sequential approach outlined in Rosefielde (1990).

<sup>12/</sup> For descriptions of the USSR and Chinese patterns of management, see Hewitt (1988) and Lin and Tidrick (1989).

the most decentralized of the socialist countries, with Hungary (since 1968) and Poland progressively moving the distribution of products onto a market basis — although with distorted prices — and according greater autonomy to firms.<sup>13</sup>

With only limited private ownership permitted, decentralization has resulted in self-management of the social or state capital within firms. In addition to the dominant role of the self-managed sector in Yugoslavia, some 70 percent of Hungarian and Polish firms are at present self-managed. "Socialism without planning" has distinctive characteristics which have been extensively analyzed. These include a lack of effective balance-sheet constraints on firms, because of i) the "absence" of effective owners and ii) extensive fiscal redistribution between enterprises, largely motivated by a commitment to full employment effected through preserving existing jobs. This adversely affects incentives, and results in chronic scarcity, impelled by a combination of expansionist management unconstrained by considerations of profitability, and workers seeking higher pay without fear of layoffs and unemployment.<sup>14</sup> Incomes are divorced from productivity by subsidies.<sup>15</sup>

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13/ China is a distinctive case. It adopted a two-tier approach to decentralization and markets, with state firms and a material supply system coexisting with a growing nonstate sector (largely in agriculture and rural industry), trading increasingly on a market basis but with different prices for similar commodities. China also has experimented with regional differentiation in its reform process, with some provinces and special zones moving far more rapidly towards markets and pluralistic forms of ownership. See Byrd and Lin (1990). Regional decentralization has progressed far in China. (Many of the prerogatives which firms have gained in ESEs have been captured by lower levels of government in China.)

14/ Authors differ in the emphasis they place on the relative importance of the absence of a well-defined bottom line for management, and the responsibility of management to the workers, in accounting for the performance of decentralized firms in ESEs. (See for examples, Kornai



Relative prices are also divorced from world patterns, with energy, transportation, and state rents normally far below world levels, credit cheap and subsidies on staple foods. Taxes and subsidies insulate domestic prices of traded commodities from their world levels.

One symptom of the distorted initial position from which market reforms are beginning in ESEs is the problem that a market socialist banking system, though superficially transformed from the monobank of the centralized system, has no basis for allocating credit according to market criteria, and for identifying and pricing risk. Credit allocation in such a situation is indeterminate, being set neither by plan nor by market. Avoiding severe macroeconomic imbalances in such a system is extremely difficult, essentially because economic agents have autonomy without responsibility.

Decentralization may reflect a deliberate policy decision to relax central planning, attempting to gain advantages from market organization without confronting the ideologically difficult issue of ownership and the technically difficult issues of transformation into a private market economy. Or, it may result from a power vacuum following a decline in the legitimacy of government, or a change of government.<sup>16</sup> In many respects, a decentralized

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(1990a) and Hinds (1990)).

15/ China's rural economy can be said to consist of product markets without factor markets, as individuals cannot move easily and interregional resource flows are constrained. However, communities face quite hard budget constraints and fiscal mechanisms to equalize incomes across them are limited, so that, on a group basis at least, incomes reflect the availability and productivity of local factors.

16/ Czechoslovakia saw moves in this direction, with workers in some firms effectively dismissing their managers through votes of no confidence, but has taken steps to reassert centralized control as a preliminary to the move to a private market economy.

socialist economy starts off the transition to a private market economy with advantages over its more planned counterpart. Agents are more familiar with markets, and their response to market incentives is therefore likely to be faster. Also, as indicated in Table 1, a larger share of the exports of the less centralized countries goes to countries outside the CMEA area and is thus subject to global competition. Firms in these countries are more likely to have had commercial dealings with foreign firms than firms in centrally planned systems, and are more likely to have had some exposure to the real needs of clients. Especially in light of the depressed conditions of CMEA members, the ability to increase exports rapidly to Western markets must be an important determinant of the speed with which reform can show results.

On the negative side, reformers of a decentralized economy must address the problem of rendering powerful and previously relatively independent firms accountable, whether to the market (by reducing cross-subsidies and/or offering them the opportunity to privatize themselves) or directly (by asserting the state's ownership rights and recentralizing decisionmaking power). Removing acquired rights is not easy, especially as a shift towards representative democracy requires maintaining a reasonable degree of consensus.

Together with measures to limit serious abuses in the course of spontaneous privatizations,<sup>17</sup> a blend of carrot and stick is in practice evolving in reforming countries to deal with decentralized firms that are not

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<sup>17/</sup> Spontaneous privatization is a process initiated by the management of a firm whereby the firm is sold, or its assets are leased, to a private corporation in which the managers and possibly workers have an interest. Spontaneous privatization emerged in Hungary and Poland, and somewhat later in Yugoslavia; it is also taking place in the Soviet Union.

yet privatized. Carrots, such as the prospect of exemption from wage curbs applied to socially-owned firms and cheap shares for employees, appeal to those in potentially profitable firms. Sticks, such as bankrupting the firm and dissolving its worker council if debts, dividends, or an annual fee for state capital are not paid, threaten the lossmaking ones.<sup>18</sup>

Assuming that opposition from its ministries has been overcome, a reforming centralized economy can consider and implement a wider range of options for addressing ownership and management issues.<sup>19</sup> Despite this advantage, it is unlikely that such economies face an easier transition. On the contrary, their greater distance from a market configuration probably implies more difficulty in reshaping institutions and acquiring necessary skills.

One important question for a still-centralized economy is whether to pass through the stage of market socialism prior to reforming to a private market economy. Because this would first involve giving ownership rights to workers, and then reclaiming those rights, this is a most undesirable reform path. Accordingly, an economy starting out from a centralized system should make great efforts to prevent ownership rights from being assumed by firms' managers and workers in an early phase of reform, by defining ownership rights clearly and assigning them as rapidly as possible to agents or institutions

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18/ Poland and Yugoslavia have adopted variants of this carrot and stick approach. In the former, failure to pay a dividend to the government triggers intervention; in the latter, late payment on debts is the trigger.

19/ Czechoslovakia is a case in point, with the famous voucher scheme being only one of many proposals under consideration. See Klaus (1990).



outside the enterprises.<sup>20</sup>

The Pre-Reform Scope of the Private Sector. Most of the ESEs have for some time codified certain private property rights, but their private sectors are relatively small (almost zero in Czechoslovakia) and are largely in crafts and distributive trades.<sup>21</sup> In some cases agriculture is substantially private (75 percent in Poland, whereas agricultural production in Bulgaria is dominated by a few public conglomerates).<sup>22</sup> In certain other socialist countries the private sector is far larger than in ESE; for example, it accounts for about one-half of the economic activity in Vietnam. Because it will be easier to relax restrictions on an existing private sector than to attempt to create a private sector from scratch, countries with substantial private sector activity and a private asset base start the reform process with a notable advantage. The strategy of first empowering the private sector and then progressively reforming the public sector and relying on the private sector to absorb laid-off employees is more viable the larger is the initial private sector.

### III. Elements of Reform

The move to a full market economy requires political changes that

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20/ We do not argue against some employee shareholding or representation on Boards, as in codetermination. However, there should be an independent locus of control on the Board.

21/ For example, limited forms of private property were legally protected from 1955 in Hungary, and their scope progressively enlarged, notably in 1968 and 1982. Private property in China and the USSR, on the other hand, has lacked a formal legal underpinning.

22/ For reviews of the private sector in four ESE countries see Webster (1990).

recognize the value of diversity and individual initiative, and that require a substantial social and political consensus. This consensus seems to exist in Poland, Hungary, and Czechoslovakia, but does not now exist in Romania or probably in the Soviet Union. System reform also requires fundamental changes in the role and organization of government. It requires countless changes in economic structure and behavior, whose nature can be understood by comparing the working of the ESEs with those of more advanced market countries. The discussion of these changes that follows is summarized by Table 2, which classifies the needed changes. Their sequencing is discussed in Section IV below.

Macroeconomic stabilization and control: The question of whether macroeconomic stabilization is indeed possible in a socialist system, or whether it requires a reform of property rights, involving the clear definition of ownership, has been raised by some analysts, notably Hinds (1990). Following the recent experiences of Poland and Yugoslavia (as well as considering the measures used to stabilize market countries with large public sectors), it is reasonable to assert that tightening of fiscal and credit policy reduces inflation and the current account deficit in socialist as well as in market economies.

However, there are some differences, which reflect the different microeconomic incentive structures between the two systems. As socialist firms know no bottom line, stabilization policies cannot rely on the same responses as those in a market economy. For example, rising interest rates may indeed encourage households to accumulate financial assets, but firms may simply refinance growing interest charges, in a giant Ponzi scheme that



initially delays reform and then renders it extremely costly. A range of direct controls will therefore be needed to reinforce indirect measures. These can include: the elimination of ex post subsidies to individual firms and the setting of strict cash limits on them, direct central bank control over the quantity of credit, and public sector wage controls. Until bankruptcy becomes a credible threat, credit control risks being undermined by a proliferation of interfirm payment arrears, especially because socialist firms tend to be closely linked in oligopolistic interdependencies.<sup>23</sup> In the face of an inefficient banking system, inter-enterprise credits can play a useful role in facilitating adjustment to rapidly changing circumstances, but the volume and distribution must be monitored, just as for bank credit.<sup>24</sup>

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The longer run success of macroeconomic tightening depends on the political resolve and the economic skill of the government, which is bound to come under severe pressure when firms run into financial trouble. A skilled government will already be working out criteria and methods for the restructuring of enterprises. It will also have to institute measures — the social safety net — to protect the living standards of those adversely

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23/ Central planning is facilitated by minimizing the number of firms to reduce the complexity of control, and spontaneous entry and exit processes are virtually absent under socialism.

24/ Yugoslavia has instituted a centralized reporting system covering both bank and interenterprise credit, and late payments on either can trigger intervention and bankruptcy.

25/ Both the phenomena discussed in this paragraph have their counterparts in market economies: firms facing a high risk of bankruptcy may attempt to borrow at very high interest rates — a tendency that leads lenders to ration credit at market interest rates; and inter-firm credit, sometimes called the gray market, tends to expand when bank credit is constrained.

affected by the economic reforms. In particular, because job loss is likely to prove the most traumatic consequence of reorganization in economies that have not previously known open unemployment, it is essential to include a social safety net for the unemployed in planning any stabilization-cum-reform program. In the beginning, measures will have to be set up on an emergency basis, because the ESEs have no administrative structures for dealing with open unemployment. Over the longer run, a more complete social safety net will have to be developed.<sup>26</sup>

In addition to measures to discipline firms and address unemployment, fiscal reform must have a high priority. With tax revenues highly dependent on profit remittances from enterprises, measures to increase their financial autonomy and at the same time absorb losses due to restructuring are likely to have a serious impact on the budget. Revenues from privatization are likely to become significant only in the medium term, even if privatization itself is accelerated; increased revenues from privatization and greater efficiency are likely to lag the increased costs associated with restructuring. Because of the uncertain size of any particular tax base in the turbulent reform environment, there are arguments for raising revenues as broadly as possible, subject to the problems posed by inadequate accounting, auditing and enforcement.

Since governments will in the longer-term have to maintain macroeconomic

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<sup>26/</sup> The far lower levels of productivity in the ESEs should be borne in mind when assessing the applicability of West European social insurance systems with their relatively high benefit levels. Because of the initially quite equal income distributions in the ESEs, it may be difficult for them to formulate comprehensive social insurance schemes and at the same time widen differentials to create adequate incentives.

control through the indirect levers employed in modern market economies, fiscal and financial sector reforms with a broader perspective than immediate macroeconomic balance have to be initiated. These reforms will be essential to increase the efficiency of the economy, and to complement the enterprise restructuring that will result in firms responding to market and interest rate signals. Such responses will not be efficient unless prices are themselves rational — and indeed, as discussed below, it may not be possible or desirable to impose tight budget constraints on firms without rational prices. This illustrates the complementarity among the elements of policy and structural changes, and the need — discussed below — to undertake certain reforms simultaneously.

Estimates of the extent of the monetary overhang vary; it is difficult to evaluate in the absence of most other stores of value, but seems to be significant in the USSR (estimates place it at about one-half of financial assets held by households) and may exist in some of the smaller countries. There are several broad options for eliminating the overhang without drawing on foreign exchange reserves or foreign borrowing: a currency reform which freezes or eliminates financial balances above certain levels;<sup>27</sup> inflation, incompletely compensated by interest rates; raising interest rates on existing assets or introducing new higher-return assets; and the sale of state assets to the public.

A confiscatory fiscal reform is problematic, especially in the context of a reform aiming to secure private property rights, but can possibly be

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<sup>27/</sup> See Dornbusch and Wolf (1990) on the effectiveness of currency reforms in dealing with the post-World War II monetary overhang in several countries.



politically justified as the result of the mistakes of the previous governments and the dubious nature of activities which had allowed individuals to build up private wealth. The inflationary route was in effect taken in Poland and Yugoslavia at the end of 1989, but is inadvisable after an adjustment process has been started, and imposes high costs of its own. Raising interest rates on existing assets, such as saving accounts, will help reduce the inflationary pressure from the current overhang — but most estimates suggest that raising interest rates to normal levels would not be sufficient to eliminate the overhang in the USSR.

There are strong arguments for the sale of public assets, especially since this approach can be made consistent with the goal of strengthening the small-scale private sector. Sale of small enterprises and premises for businesses and retail shops is one example; sale of the housing stock is another, though this would need accompanying measures to raise the cost and reduce the security of renting, and these, in turn, would require adjustment of pay levels to reflect higher rents. Because rents are usually far below maintenance costs, even giving housing away would improve the budget on a flow basis. It has though to be recognized that privatization is likely to be a slow process. One possible strategy — not yet used in the ESEs — is to combine currency reform with the sale of assets. Asset holdings above a certain level can be frozen and their subsequent use permitted to purchase assets that are being privatized.

Consider now external balance. Especially once measures are taken to harden budget constraints and restrain domestic demand, exchange rate changes should be effective in switching expenditures and output in socialist

economies, provided that price reform creates a link between world and domestic prices for tradeables. However, again the distinctive institutional arrangements of the ESEs constrain the likely response. Over half of the exports of the ESEs go to countries in the CMEA system. Many of these products are not of adequate quality and appeal to be acceptable on world markets. Within the unreformed CMEA system, trade flows were arranged through inter-government protocols rather than being responsive to relative prices.

Except for the USSR (which exports hard currency commodities), the imminent comprehensive reform of the CMEA system towards multilateral, market-based, trading (which is a logical complement to internal reforms) raises the problem that each reforming country's exports must compete in previously sheltered markets with superior products from the West. Reforms in one socialist country as well as in the trading system can render more difficult the short-run task of maintaining external balance in the other reforming countries. Indeed, exports from certain small ESEs to the West could actually fall because of the need to divert world-quality products to the USSR to pay for essential imports of fuels and raw materials. In the longer-run, of course, reform of the CMEA system will have a positive effect on the economies of its members — and certain countries, notably Hungary, have already demonstrated their ability to increase exports to the West quite rapidly.

In sum, stabilization measures involving a combination of controls on aggregates and specific interventions can be effective. But, given their economic rigidities, narrow markets and small convertible-currency trade ratios, the response of socialist systems to expenditure reducing and switching measures is likely to be less rapid and more costly in terms of



output than is typical in market economies. Further, the cost is likely to be raised by simultaneous reforms in other ESEs, due to the disruption and loss of protected markets.

Institutional and complementary reforms. Institutions and professions that are taken for granted in market economies have to be re-created in the reforming socialist economies. Legal, regulatory, and information systems need to be reformed to support markets.<sup>28</sup> A secure legal environment has to be created for the protection of property rights and the regulation of commercial relations. Accounting and audit systems are needed to organize and monitor information. Complementing such system reforms are needed investments in human capital, in areas such as accounting, credit and market analysis, and bank inspection. Management skills have to be upgraded and modernized, especially in the areas of finance and marketing. In some areas, such as financial markets, reform may require a greater state role than before.

When assessing the efforts underway to change legal and regulatory institutions in reforming socialist countries rapidly, it must be remembered that those of the market economies have evolved over centuries. Such reforms and the creation of human capital appropriate to a new system, are lengthy processes which pose a constraint on the efficiency and speed of reform.<sup>29</sup> They also constitute an area in which foreign assistance may be especially

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28/ One suggestion is that a reforming economy take over and adapt a complete legal and regulatory system from a market economy with historic and cultural ties. For example, Hungary and Czechoslovakia might adopt and adapt the Austrian framework. East Germany has, of course, essentially simply adopted the institutions of the FRG.

29/ Consider for example that in the United States it takes a minimum of five years to train an examiner capable of dealing with the smallest and simplest bank.

useful in the transition.

Price and market reform. Given the mutual interdependence of prices and their sheer number (some 25 million even in the planned Soviet economy), the process of moving to a more rational set of prices could be highly complex and extended. Fortunately, the rational price system needed for increased enterprise autonomy to make sense is known: it is world prices. The best way to introduce rational prices is to open the economy to foreign trade. An open trade (and current payments) policy also exposes domestic producers to foreign competition, and offers the prospect of more rapid increases in the quality of products, through a range of licensing, processing, marketing and other joint venture arrangements with foreign firms. This route is certainly available for the ESEs, which will become more open as they reform, and which can expect considerable growth in trade (especially intra-industry trade) with market economies.<sup>30</sup>

The Polish government's move to current account convertibility (at a heavily depreciated exchange rate) should thus be seen not only as a way of improving the current account, but more importantly as an essential and immediate move to a rational price system that helped force competition. In practice, some price distorting tariffs will remain: uniform tariffs can be

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<sup>30/</sup> Open foreign trade provides a rational price system for traded goods, but of course not for non-traded goods. And until the capital account of the balance of payments is opened, interest rates and asset prices can also diverge from world levels. For a large, closed, economy like the USSR, it is less clear that a rapid move to world prices would be the most appropriate strategy. However, even in the case of the Soviet Union, a rapid liberalization of trade, combined with gradually declining tariffs, would provide potential markets for exporters and an important element of potential import competition for domestic monopolists, thereby helping create the appropriate relative price structure.

justified as a source of fiscal revenue, but it would be only realistic to recognize that the reforming ESE governments are no more likely to move immediately to undistorted trade than are other governments. Nonetheless, world relative prices are the right reference point.

Trade and domestic reforms are mutually dependent. Domestic deregulation, in agriculture, industry, and services, and enterprise reform has to take place if firms are to respond appropriately to price signals. Some analysts (Nutti 1990) seem to argue for liberalizing internal markets and reforming administered prices before liberalizing international trade. But such reforms are more likely to succeed if an appropriate price system is already in place — and liberalized trade can be an important element in producing such a price system.

Price liberalization is also necessary for the credible long-term hardening of budget constraints. Until prices are rational, profits and losses are not necessarily good indicators of efficiency, and are therefore not a good guide to decisions on which firms should be closed and which should obtain financing for increased investment. Closing a firm whose output price is held below its social value is not necessarily an optimal response to its financial losses. Firms cannot easily be held accountable for their profitability if government sets their prices.

Because of past patterns of industrial organization, additional measures may be required to develop competitive markets. These are likely to include active and early demonopolization of transport, distribution and trade systems. They may involve the breakup of large conglomerates formed, not in response to market imperatives, but to reduce problems of control and to



secure inputs in the shortage socialist system. Though demonopolization is needed, it should be approached with an international perspective, especially for a small country. As a method of enhancing competition, the opening up of trade is likely to be preferable to fragmenting firms to achieve competition on the domestic market.

So far, only product prices and markets have been considered, but the creation of factor markets and liberalization of factor prices are also important. They are discussed later.

Enterprise reform. Enterprise reform — in all sectors, not only industry — is the heart of the transformation process. As in all areas, the process requires interrelated changes: the imposition of bottom line discipline, definition and change of ownership, and reform of management arrangements. The ownership issue is a political mine field: workers in worker-managed firms believe they have substantial claims on the firms; insider sales of firms by and to former managers and bureaucrats (spontaneous privatizations) create inequities. How to respond to such sales, which are likely to be the first reactions to liberalized regulations, is an important policy question for the government. Political reaction against initial bursts of spontaneous privatization in Hungary and Poland resulted in their suspension, and a lull in privatization activity in these countries. Sales of firms before their value can be determined in a realistic price system are likely to be inequitable ex post; and nationalist sentiment in all countries will put some limits on the role of foreign ownership.<sup>31</sup> The ownership of agricultural

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31/ China's rural reform, in which communes were in effect privatized to their members, stands as the most impressive example of property rights reform among socialist countries. The introduction of the household



land poses another set of politically-charged issues.

Corporatization — a change in the status of a firm, to render it a joint-stock or other form of corporation — is normally the first stage, but restructuring and privatization are the two real phases of enterprise reform. Opinions on which should come first differ.

a) Slow privatizers argue that firms should be sold off gradually after restructuring, in a more rational price system, after the new rules of economic behavior begin to emerge, and after a real business class has had time to develop to exercise the ownership function. The prices of firms will be more realistic, and the sales process more equitable, both because the new owners will pay the right prices, and because the government will obtain more revenue. Slow privatizers point, for example, to the privatization process in Britain, and cite the need for "real owners", private agents with a long-term view and sufficient equity in a given firm to encourage an active role and give a strong measure of control. They suggest also that premature privatization may unnecessarily create interest groups of shareholders who object to the removal of distortions, such as subsidies, which impact adversely on the value of their assets.

b) Fast privatizers argue that more comprehensive and rapid ownership reform is necessary to increase efficiency.<sup>32</sup> A further argument is political.

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responsibility system has been shown by Lin (1986) to have been responsible for most of the increase in agricultural output associated with the Chinese reforms. Such reforms are probably far more difficult in an industrial setting, and in a less authoritarian system.

<sup>32/</sup> Discussion of the Hungarian reform process provides examples of the distinction between slow and fast privatizers, with Kornai (1990) as a slow privatizer, and the Blue Ribbon Commission (1990) arguing for fast privatization. The period that has been suggested appropriate for

Without the power of a substantial capitalist class behind it — and it is agreed that such a class will not emerge rapidly, the reform process will surely be subverted and prematurely terminated by the interest groups representing adversely affected segments of society, such as potentially laid-off workers and redundant bureaucrats. Reform must be radical and fast-moving, to deny such groups the opportunity to coalesce. It is widely accepted that more rapid privatization reduces the expected total sales revenue to the state; fast privatizers argue that the benefits of a rapid and irreversible shift to private production outweigh the costs of reduced state revenue, and that higher tax revenues from a more efficient economy offset the loss of revenue from rapid privatization.

A number of schemes has been proposed to achieve the goal of rapid privatization in an equitable and politically acceptable fashion, and in doing so to overcome the problem posed by uncertain asset valuation. The schemes typically involve creating shares in existing companies, and distributing them on a broad basis within the country. Most proposals recognize that very dispersed ownership does not provide a basis for effective control, and therefore include a mechanism to create a dominant shareholder or group of shareholders to monitor the management of individual companies. Some offer employees preferential access to a block of shares, as an efficiency incentive, and to render the process acceptable to them. Consider two approaches:

- i) Create holding companies or unit trusts to be dominant shareholders,

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privatization of a major part of industry ranges from less than three to around thirty years in various studies.

sufficient in number to ensure competition among them. The state can retain a bloc of shares for later sale or distribution to citizens, thereby ensuring that the benefits of privatization are shared by the public. It can also offer citizens shares in the holding companies, so offering them diversified portfolios. The difficulty here is to ensure that the dominant shareholders operate like private owners, when they are not (unless of course, they consist of foreign owners who have sufficient wealth to buy the shares). There is also the risk that privatization may stall at some intermediate stage.

ii) Distribute shares of each enterprise equally across the population and initiate trading arrangements to enable dominant ownership groups to emerge. Whether an effective ownership group would actually result from such a process, and whether the large ex post inequities that are likely to arise are acceptable because of ex ante fairness, are important questions.<sup>33</sup>

No country has yet implemented schemes of these types, but they are being actively discussed and implementing legislation passed in Czechoslovakia and Poland.<sup>34</sup>

A variety of approaches is likely to be adopted in practice. Consider first firms in potentially competitive sectors, and suppose that price reform and macrostabilization have progressed sufficiently to make reasonable

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<sup>33/</sup> Of course, without an adequate information base, no stock market established at an early stage of reform would offer a useful basis for valuation or any indication of desirable investment patterns. The purpose of the initial exchanges is, however, quite different.

<sup>34/</sup> See Lipton and Sachs (1990) for the presentation of a rapid privatization scheme, involving the distribution of shares, for Poland.



viability judgments possible.<sup>35</sup> Small weak firms should be closed and their assets and premises sold off; small stronger firms could be privatized rapidly, possibly being sold to all or some of the existing employees, with the state offering some seller finance. The state will have to handle the large weak firms, with extensive restructuring needed to move them into the private sector if they are not closed.<sup>36</sup> The larger firms with potential are the crux of the privatization problem. Many could be privatized, at least in part, relatively rapidly. Foreign investors are already active in each country. In some cases they could either take on the role of dominant shareholder (possibly on a temporary basis) or could manage the firm on contract for a domestic holding company. Shares in such firms could be distributed under the schemes discussed above.

Whatever the precise rapid method used, it is likely that state holding companies will play an important ownership role in the transition. Given the scarcity of domestic owners and the undesirability of a fire sale to foreigners, there seems to be no alternative. Some form of holding company structure would likely also be needed under the slow privatization option, as a vehicle for the state to assert its ownership through the stage of restructuring. In the longer run, holding companies may be privatized; alternatively they could be converted into pension funds by transferring to

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35/ In the early stages of reform, many potentially viable firms are likely to experience severe liquidity — and possibly solvency — difficulties, due to exceptionally depressed markets, disruption of CMEA trade, and exceptional interest charges. These short-run difficulties greatly complicate the task of deciding whether to close down or support any given firm.

36/ It seems doubtful that the private sector could handle restructuring of very large, weak industries because of the potential political reaction.



them the appropriate liabilities. Foreign management may be a useful intermediate stage; so might foreign ownership although there are political limits to this and it is anyway inappropriate to sell national assets off too cheaply out of very short-term considerations.

In line with European tradition, and considering the regulatory difficulties, natural monopolies should probably not be privatized early, unless perhaps this is particularly needed to attract large foreign investments to facilitate restructuring and modernization.

Financial markets. The development of financial markets and private sector financial institutions, including banks, is an essential step in the transition to a market economy, and in moving investment decisions away from government control. Indeed, many reforming socialist countries have taken steps in this direction, including moving from a monobank to a two-tier banking system; several of the ESEs are also discussing the rapid creation of a stock market. But there are important differences between enterprise reform and the reform of financial institutions, which imply different treatment in the overall system reform.

More so than other sectors, financial markets depend on underlying legal and informational systems and skills that barely exist in ESEs. Further, the problems of existing loan portfolios, which are very substantial in the reforming ESEs, have to be addressed before a sound banking system can emerge. Existing loan losses, which originated when the central bank's portfolio was allocated to the commercial banks, will have to be moved off balance-sheet and allocated, either to depositors or other lenders, or absorbed by the budget. In addition, large loan losses that will appear as relative prices and demand

patterns shift in the course of domestic and trade reform will need to be handled in a similar way. The banks should be recapitalized and expected to function as market institutions only after the economy has settled down sufficiently to enable loan portfolios to be kept reasonably clean. And before then, the proliferation of banking institutions should be constrained, and emphasis on competition in financial markets be moderated, although some entry of foreign banks, as participants or managers of domestic institutions, can play an important role.

The differences between banking reform and enterprise reform occur because the condition of the firms determines the state of the banks' portfolios, their earning potential and their equity (assets corrected for expected loan losses less liabilities). If their equity is zero or negative - as is the case in several and possibly all ESEs, banks face perverse incentives in mobilizing and allocating credit; these incentives lead to viable borrowers being crowded out. If banks' budget constraint is hardened without restructuring portfolios, they will attempt to compensate for a high share of nonperforming loans by raising charges to paying clients.<sup>37</sup> The latter will face extremely high costs of credit because of large banking spreads. Under such conditions it is likely that it is mainly firms in potential financial trouble that will borrow from banks.

A truly competitive banking system therefore cannot be expected to emerge before the processes of enterprise restructuring and price reform are substantially under way. This raises several sequencing issues, which are addressed below, including the question of how new firms are to be financed

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<sup>37/</sup> This process is apparently taking place at present in Yugoslavia.

early in the transition process. Other important questions to be considered are the ownership of banks (they should not be owned by client firms) and whether banks should have an ownership role as in Germany and Japan. The last point is less important at the start of reform, because the banks have no obvious capability to exert a positive ownership role.

#### IV. The Sequencing of Reforms

Administrative feasibility alone ensures that not all reforms can be instituted simultaneously. The more fundamental reason for sequencing reforms is that some changes are preconditions for others: for instance, macroeconomic stabilization is needed if price reform is to be successful. It is necessary to develop systems and skills that have to be in place for markets to work. To take an important example, financial liberalization is extremely risky unless a sound system of accounting, auditing, prudential regulation and supervision is in place, and unless the macroeconomy is reasonably stable.

The sequencing problem has been extensively studied in the analysis of the structural adjustment of developing economies. While some rules of thumb emerged in that context,<sup>38</sup> the more important conclusion is that a linear sequence of individual policy changes is not the right concept. The problem is better thought of as one of the packaging of reforms: the need is to introduce groups of complementary policy reforms, sequentially.

The details of the reform path to be followed by a country depend on the

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<sup>38/</sup> For example, that when inflation is rapid, macroeconomic stabilization is needed before reforms that change relative prices — such as trade reforms — are undertaken, that goods markets should not be liberalized later than factor markets, and that the capital account should generally be opened after the trade account.

state of the economy, on the tolerance of the population for the disruptions that are sure to accompany the reform process, and on the political situation in each country. Nonetheless in Figure 2 we outline a prototype reform process for a representative ESE country, with initial conditions somewhere between those of Poland and Czechoslovakia.

For countries with high inflation and non-sustainable balance of payments deficits, macroeconomic stabilization has to be the initial priority. The severity of the program and the range of accompanying structural reform measures will reflect the extent of initial imbalances and political judgments about what is acceptable to the population. A new government, or a government with support for radical change, has far more leeway, and should use it, for it is harder to impose tough measures later.

For an extreme case, such as Poland, stabilization in a way consistent with a move towards a market system included sharp cuts in firm-specific subsidies and tight credit limits. It also included trade liberalization on a major scale, and at a heavily depreciated exchange rate. In high inflation countries, it may be necessary in the initial phase of stabilization to fix the nominal exchange rate to provide a nominal anchor for the price level. It is also necessary to create an emergency safety net that shifts social protection off the shoulders of firms, thereby facilitating resource reallocation — which in the case of labor means unemployment.

While initial success in reducing inflation from very high levels can be achieved within a few months, stabilization can be assured only by following consistent policies over periods of years. During that time, measures to allow indirect macroeconomic control should be put in place. It may take



years for the expectation of macroeconomic stability to become sufficiently ingrained to affect long-term economic decision-making. A particularly difficult stage for reforming governments comes a few months after the success of the initial phase, when unemployment is rising, firms are beginning to experience financial difficulties and closings are in sight. Inflation is lower, and the demands for reflation — meaning an easing of credit constraints and reinstatement of some subsidies — are pressing. For this reason alone, governments have to move quickly after stabilization to formulate measures for the emergency restructuring of firms.

Price reform for goods is shown as taking place early as a prerequisite for decentralization and tightening budget constraints, with trade reform an important element. Progressive reductions in state interventions continue the process.

Wage determination presents a major challenge. In socially owned firms (the great majority) wage-setting cannot be left to the market early in the process, because the firms are not operating under correct price and management signals. At the same time, wages must respond to inflation and changing relative prices, including those (such as the introduction of more realistic rents) needed to place the housing sector on a sound basis. Wage guidelines or formulae have to be used initially in non-privately owned firms;<sup>39</sup> wage determination can increasingly be left to the market as firms are restructured and privatized.

Realistic interest rates are needed to attract depositors into the banking system and to provide a reasonable measure of the cost of financial

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<sup>39/</sup> In the case of Poland, wages were partially indexed.

resources to firms. But it will not be possible to leave interest rate determination to the market until far into the reform, because the appropriate incentive structures for firms and banks will not be in place. Premature reliance on the financial market as an instrument of indirect economic management is likely to raise real interest rates to the point where they create financial difficulties even for firms that would be sound in normal times, and to provoke costly financial crises.

Measures to eliminate regulatory discrimination against the private sector can be taken at the start of the process.<sup>40</sup> Privatization of small firms can also start immediately, with small-scale commercial bank lending needed in support. Whether or not some holding company mechanism is used as an intermediate stage or some shares are distributed across the population, preparation for the restructuring and "real" privatization of most larger firms is likely to take several years, and the execution to take much longer. Preparation, including corporatization, has nonetheless to begin as soon as possible. Clarification of ownership rights, and the movement of responsibility for the direction of firms to Boards of Directors, should be implemented as rapidly as possible.

Banking system reforms involve several stages. Preparation can begin immediately, with the establishment of suitable accounting and asset valuation standards, reform of banking, contract, enterprise and bankruptcy laws and the drafting of prudential regulations, as well as staff training. Next come audits of firms and banks and asset valuations, followed by portfolio

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<sup>40/</sup> Hungary, Poland, Czechoslovakia and Yugoslavia have all taken steps to place private firms onto the same legal and regulatory footing as public firms.

restructuring (the counterpart to enterprise restructuring), allocation of losses, and recapitalization. Only after this process is complete can a market-based banking system emerge.<sup>41</sup>

From a purely technical perspective, equity markets can probably be created quite near the start of the reform process. But, apart from their possible initial role in consolidating claims noted above, they will only be a facade because valuation and information deficiencies will prevent them from playing a useful role in the allocation of resources.<sup>42</sup> Evolving such a role will take years and they should not be developed on any significant scale until the banking system has been restructured.

The need for financial sector reform not to outrun enterprise reform raises the important question of how the emerging private sector is to obtain financial services in the interim. One possibility is to establish specialized financial institutions for the private sector. A better solution, given the need for the banks to acquire the capabilities needed to serve private clients, is to implement a two-track strategy for the banking system, with private sector service departments in all major banks, initially on a small scale, and the separation of assets in private and publicly owned entities.

We do not show a separate line for international trade in Figure 2.

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<sup>41/</sup> This is not to say that the banks cannot at all be active participants in the restructuring process. Indeed centers of expertise can be usefully developed in the banks, but responsibility for the process and its financing must lie outside the banking system.

<sup>42/</sup> In China, for example, equity issues can be found despite the absence of laws defining private property rights. Liabilities combining features of debt and preferred shares are also issued, but without clear definition of holders' rights and the basis for their returns.

That is because reform of goods trade is treated as an element of price reform. Current account convertibility, which means essentially unrestricted access to foreign exchange for current account transactions, is desirable as an early part of the reform program.<sup>43</sup> It is particularly important to make provisions for the treatment of foreign investors early in the process. Capital account convertibility should come later, when expectations of stability have been established.

This simple treatment of trade and payments issues ignores, however, the need for reserves to be adequate prior to liberalizing the current account. Poland's reserves had been augmented by standby agreements, and Poland enjoyed a de facto moratorium on debt service; Yugoslavia had accumulated reserves prior to initiating its major reforms. Countries in the position of Bulgaria, with essentially no reserves, face greater risks in opening their current accounts. Also ignored are complications arising from the changing CMEA regime. In addition to the product quality issue discussed above, CMEA reform is likely to exacerbate the reserve problem by raising the share of trade for which normal reserve cover is needed.

Figure 2 shows how much has to be done at the beginning. Virtually all the reforms, or at least their planning, have to start quickly, even though implementation may take a decade. Of course, Figure 2 exaggerates the precision of the process, and it certainly does not show the setbacks that are inevitable in any economic reform program.

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<sup>43/</sup> Some countries may elect to use dual exchange rates and important licensing for some transitional period. In these cases, it would be important for firms to have access to foreign exchange and automatic import licenses in the free foreign exchange market.



Figure 2 also cannot show one other vital element. A government that starts out with a clear idea of what it wants to achieve and with a popular mandate to move in that direction, and that resolutely pursues its goals, will transform the economy more successfully than a government and a society which is not sure of what it wants. For this reason, reform is more likely to succeed in those countries where there is a consensus on the necessity of moving to a normal private market economy.

#### V. The Role of Foreigners

The success of economic reform in ESEs depends heavily on the extent to which the reforming governments open their economies to foreign trade, capital, and expertise, and the response of Western economies and governments. Opening to foreign trade immediately puts in place the right price signals, allows countries to benefit from larger markets, and from foreign technologies. The proximity of Western Europe makes these benefits obvious to the reforming governments, and to those contemplating reforms.

The reforming governments have welcomed foreign direct investment, though it is not yet taking place on a large scale except in the former East Germany. It will be necessary for ESE governments to develop a systematic approach to foreign investment and foreign ownership, recognizing that the right approach is not to create special incentives for foreign investors, but rather to create conditions favorable to both domestic and foreign private investment.

Official foreign finance is also needed to ensure reserves, cushion the short-run impact of stabilization, and to help develop infrastructure.

Bilateral support except for East Germany has been limited so far, but the multilaterals have started lending on a large scale. The potential role of the new EBRD as a lender to the private sector is important, especially given the reluctance of commercial banks to become involved, but it will take some time to work out how public money should be channelled to the private sector.

Foreign expertise, from both the private and official sectors, is avidly solicited by ESE countries. It is essential to expand the use of management contracts and other methods of using experts with the down-to-earth knowledge of how to run businesses and the other institutions that support a market economy.

What should Western governments do to help the reform process? They cannot intervene directly in the intense political ferment that in the end will determine many aspects of the reform process, but they can make four important contributions:

- . Market access: With generally restrictive domestic spending policies and the need to upgrade to Western standards, access to the markets of industrial countries is vital for a rapid return to growth. It is extremely important that the industrialized countries open their markets to exports from the ESEs.
- . Technical assistance: The needs of the reforming countries are enormous. Because of their relatively high levels of literacy and numeracy, the payoff to a period of intensive and well-coordinated technical assistance, will be high. Direct, firm-level, assistance can be especially useful.
- . Financial assistance: Some countries, especially Poland, embark on

reform with crushing debt burdens. Relief is an essential ingredient of reform, as is continued access to capital to finance restructuring and provide a cushion during the transformation process. Assistance aimed directly at cushioning the impact of restructuring can also play an important part.

Coordination: Present aid efforts are so ill coordinated that they stretch the already overstretched implementation capacities of the reforming governments. Coordination has to be improved.

## VI. Conclusion

This paper has attempted to define the main components of system reform programs aimed at transforming a socialist economy into a private market economy. Initial conditions that shape reform have been discussed, together with the complementarities between major elements of reform and the need for certain reforms to precede others for a program to be consistent. The paper then sketched out an illustrative schedule for such a program for a representative country.

In practice, any given country will face many choices concerning its reform path. Some of these will involve differences in the target of reform, the ultimate form of the private market economy. In general terms, the organization of such economies is quite well-defined, but there are important differences across industrial countries. In some, the state plays a more active economic role than in others, social insurance coverage and collective bargaining methods differ widely, and so on. Economic theory offers relatively little guidance for making decisions on the distribution of wealth

across the population. There are also important choices to be made concerning the role of foreign ownership and control. Such differences obviously will affect the design of specific programs.

Even with consensus on the elements of reform, implementation can generate substantial debate. For example, the approach towards regulating natural monopolies differs as between the US and Europe, tax codes and banking regulation and supervision are not uniform. In some of these areas, flaws are apparent in certain potential models which have evolved over time.<sup>44</sup> But more often the most important consideration in shaping reform may be to ensure consistency with potential trading partners and sources of capital, so that differential regulation does not impede economic integration.

The important strategic choices, however, arise out of the interplay between economics and politics. System reform is an intensely political process, and the imperatives of political sustainability may dominate the analysis of the reform process: indeed, the major differences between alternative proposals for reform reflect, to a large extent, different strategic views of what will be sustainable. The time needed to reform institutions, create skills—including the re-instatement of a business class—and establish valuations argues for a measured pace of reform. But such a slow process has costs, including prolonged uncertainty and perhaps an extended period of poor asset management. It runs the risk that opposition to the changes will coalesce to terminate the process. This leads to the rapid approach, wherein markets are apt to be liberalized prior to adequate

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<sup>44/</sup> For example, few would now recommend adopting the organization of the US banking industry or the institutional fragmentation of its regulators.



preparatory steps and owners to be created early, either in the form of various holding arrangements or spontaneously by trading claims. The rapid approach to reform has definite merits, especially if reserves have been built up to tide the country over the period of economic disruption that is likely to follow. However, it too runs high risks, because of the potential for chaos.

Especially in this situation, technocratic solutions are not sufficient. In addition to trying to define optimal, or even feasible, transition strategies, economists must have an eye for the major inconsistencies, risks and dead-ends likely to result from strategies driven by political processes, and must seek ways to defuse such problems, if possible before they become serious enough to undermine reform. At the same time, politicians have to recognize that the present crises have been created by the neglect of economic factors, and that political considerations alone cannot drive the reform process.

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Table 1:  
BASIC DATA ON EAST EUROPEAN ECONOMIES

	Alb- ania	Bulg- aria	Czech.	East Ger.	Hungary	Poland	Romania	USSR	Yugo.	USA	West: Ger.
Population (millions)	3	9	16	17	11	38	23	283	23	244	61
Area (,000 sq. km)	29	111	128	108	93	313	238	22402	256	9373	249
GNP (CIA) \$bn. <sup>1</sup> 1206	-	68	158	207	92	276	126	2535	154	4881	-
1988 % of U.S. per capita	-	38	51	63	44	37	28	52	33	-	-
Exchange Rate Estimates % of U.S. <sup>2</sup> per capita	-	13	18	35	13	9	16	19	11	100	-
GDP Physical Indicators 1988 % of U.S. <sup>3</sup> per capita	-	30	42	45	32	27	21	na	22	100	-
Bal. of Payments (\$bn.), 1989	-	-1.1	-0.1	0.7	-0.7	-1.3	2.1	0.1	1.5	-115	60
Hard Currency Debt (\$bn.)	-	5.5	4.0	10.0	15.4	35.6	0.8	30.5	17.7	-	-
Life Expectancy at Birth	72	72	71	73	70	71	70	69	71	75	75
Infant Mortality Rate	39	15	13	9	21	24	na	25	24	14	15

<sup>1</sup> CIA, Handbook of Economic Statistics, 1989.

<sup>2</sup> Tentative estimates, using IFS data where available and staff estimates in other cases.

<sup>3</sup> Eva Erlich, "Absolute and Relative Economic Development Levels and Their Structure 1937-1980", Budapest, 1987, mimeograph, P. 15.

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na: not available



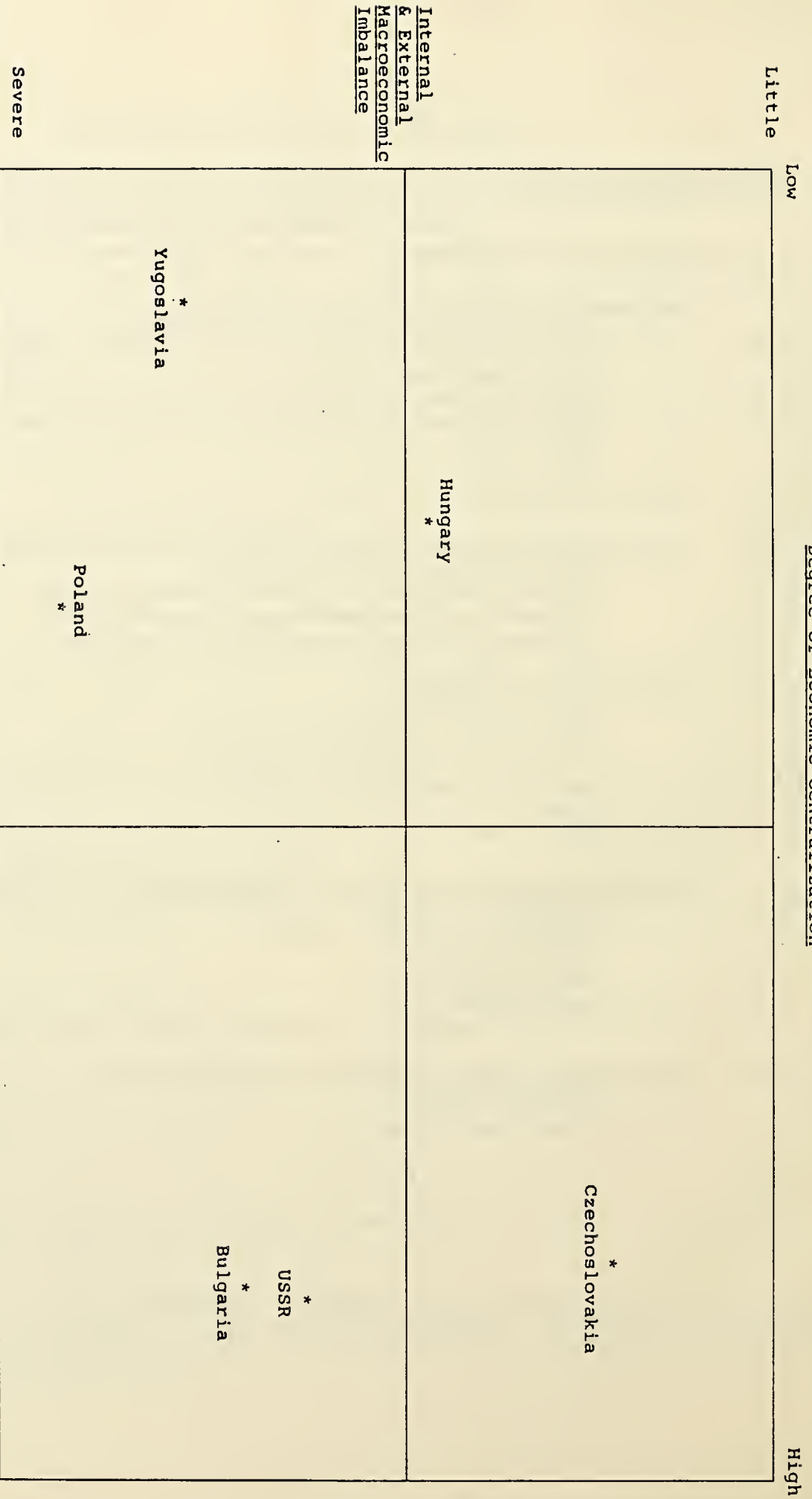
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Table 2:  
ECONOMIC ELEMENTS OF SYSTEM REFORM

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1. Macroeconomic stabilization and control
  - Implementation of stabilization programs
  - Creation of tools and institutions for indirect macroeconomic control, monetary and fiscal
  - Measures to harden budget constraints
  - Dealing with existing problems (monetary overhang, financial system bankruptcies)
- 1a. Social Safety Nets (at first on an emergency basis)
2. Institutional Reforms: Human Capital and Administrative Capacity
  - Legal and regulatory institutions
  - Business management, including financial sector
  - Government decision-makers and administrators
  - Information systems (accounting and auditing)
3. Price and Market Reform
  - Domestic price reform
  - International trade liberalization
  - Distribution systems for products
  - Creation of market for housing
  - Wages
  - Interest Rates
4. Small and Large Scale Enterprise Restructuring and Privatization
  - Management systems
  - Allocation of property rights
  - Agricultural land
  - Industrial capital
  - Housing stock
  - Social protection and insurance rights for individuals
5. Development of Financial Markets and Institutions
  - Banking systems
  - Other financial markets

Initial Conditions for Socialist Reform Process  
Degree of Economic Centralization

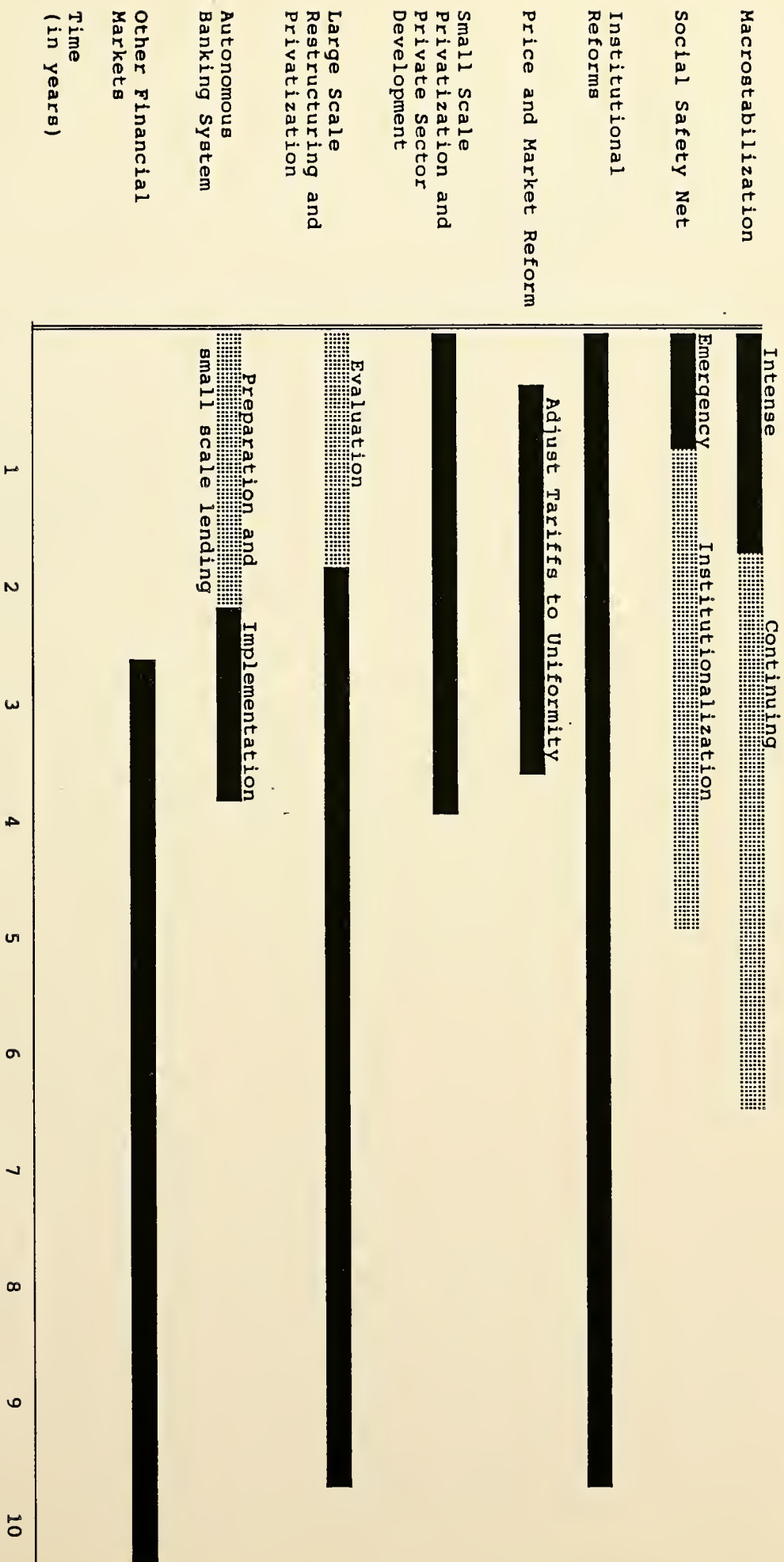


Internal  
& External  
Macroeconomic  
Imbalance

Severe

Figure 2

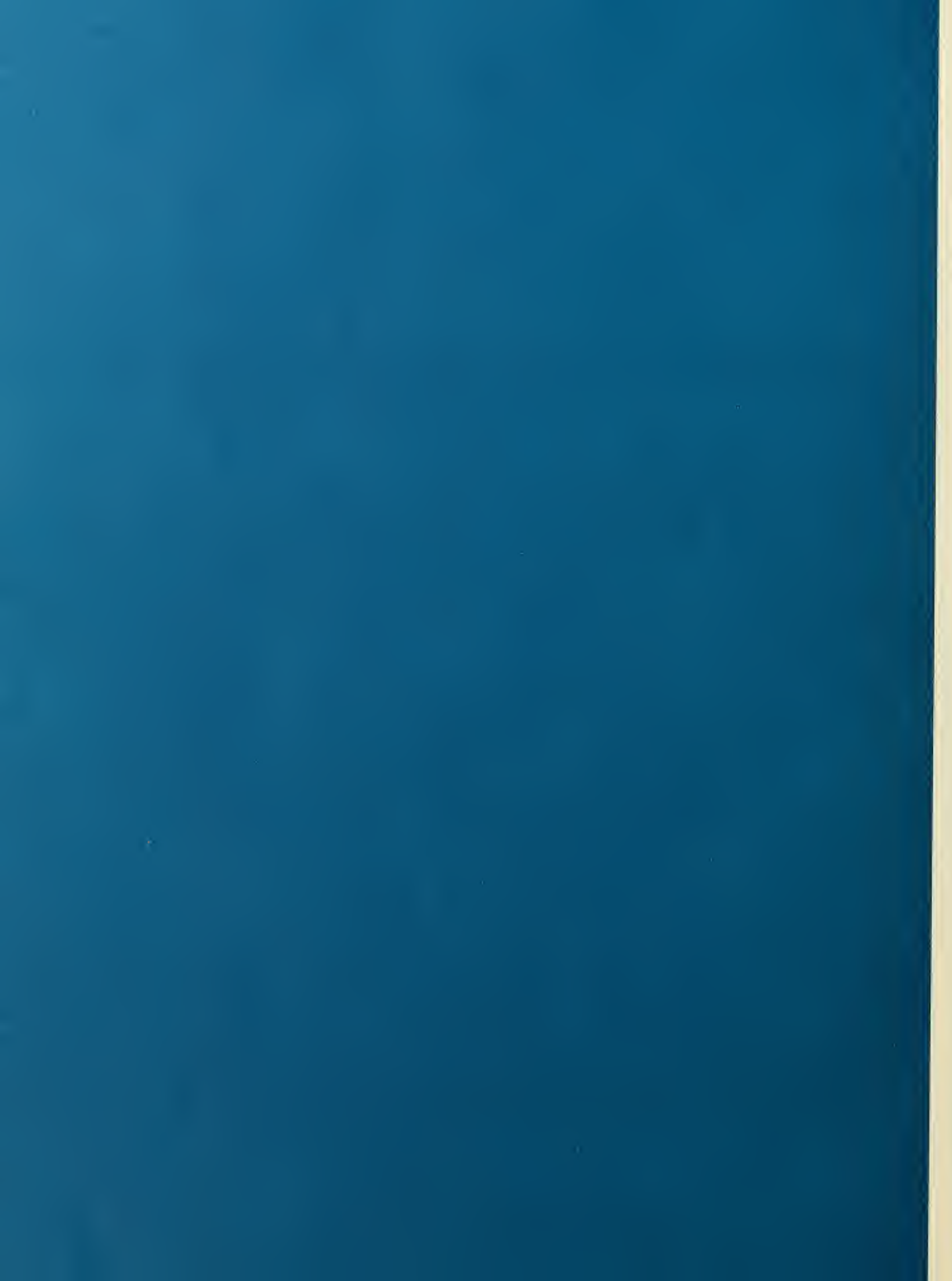
Phasing of Reform













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